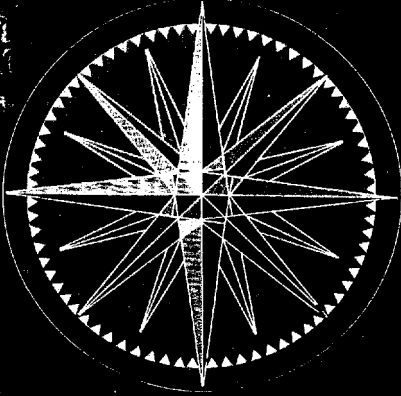


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INFLATIONARY PRESSURES IN THE USSR

CENTRAL INTELLIGENCE AGENCY

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INFLATIONARY PRESSURES IN THE USSR

Inflationary pressures have been developing in the USSR during the past several years because the output of consumer goods has not kept pace with increasing incomes. The regime is concerned primarily because of the effect these pressures have on production incentives and also because of their less direct effect in bringing about popular discontent. Moscow's choice of means to fight inflation--short of providing additional resources to the consumer program--is made difficult by its recognition that the people are less willing to accept economic restrictions than they once were.

The Soviet Consumer
Under Khrushchev

While the consumer has always been the stepchild of the Soviet economy, his fortunes have been improving since World War II. Khrushchev has boasted of this improvement and has made sweeping promises for the future. Although resources allocated to consumer interests have not been significantly increased, more consumer durables have been produced each year, the food situation has improved, and the official promise to end the critical housing shortage has seemed attainable. At the same time, rising incomes have enabled workers and peasants to take advantage of the increased opportunity to improve their standard of living.

In 1961 and 1962, however, the rate of improvement in consumption levels slowed down, and in 1962 the consumer experienced several shocks unprecedented in the Khrushchev era and unlikely to increase his confidence in promises for the future. A 30-percent rise in retail prices for meat and butter, the "temporary" suspension of income-tax cuts, and the news that, for the third year running, the housing plan would be underfilled by a large margin all came in quick succession. The year-end reports on plan fulfillment, while better than in 1961, still showed a particularly spotty performance in the consumer sector.

Khrushchev's reason for adding to the woes of the already discouraged consumer apparently lies in the inflationary trend over the past two to three years. Consumer industries and agriculture have not been able to keep up with the demand resulting from increased disposable incomes. Before 1955, consumer output grew faster than disposable income, permitting a substantial reduction in prices on consumer goods. From 1955 to 1959 there was a rough balance in the two rates. However, since 1960 the upward trend in consumer disposable incomes has been allowed to continue--in part for incentive purposes--while the rate of growth in consumer goods output has fallen off.

Prepared by the Office of Research and Reports

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Development of Inflation

Although Moscow has described the prevention of inflation as its "primary explicit financial objective," the USSR has nearly always been plagued with inflationary pressures that would be unacceptable in a free economy. After the monetary reform of 1947, inflation was contained through such measures as more effective controls over wages, a rapid advance in the output of consumer goods, and limitations on the amount of new cash in circulation. The setting of more realistic plans meant also that enterprise managements were under less pressure to recruit and thereby bid up wages. The early success of Khrushchev's agricultural policies provided a major bulwark against inflation during the early 1950s, when high rates of growth in the output of consumer goods permitted drastic reductions in retail prices.

After 1955, instead of raising real incomes by general price reductions, the emphasis changed to one of raising incomes selectively through expanding welfare payments, cutting income taxes beginning with the lower income levels, and raising agricultural procurement prices. But between 1955 and 1959 the increases in goods and services available for purchase were barely keeping up with the rise in disposable income.

Nevertheless, in 1958 Khrushchev, perhaps basking in

the success of stamping out the price inflation characteristic of the prewar and immediate postwar years, proclaimed:

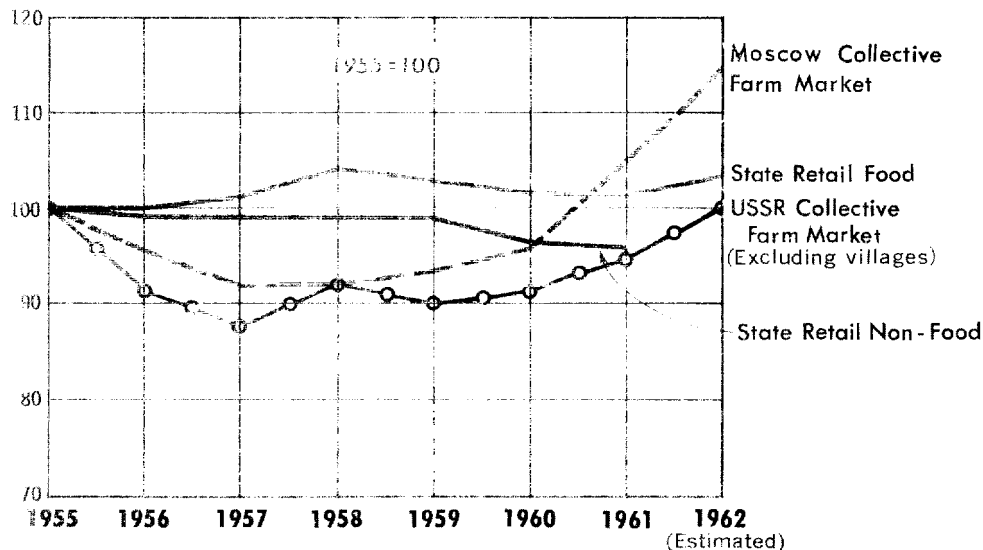
There cannot be any inflation in our country, for in preparing the budget and product plans, we take into account the sum of money to be paid in the form of wages and the necessary quality of goods to be manufactured in order to maintain the balance between the stock of money and...manufactured goods.

In relating the early success of the Seven-Year Plan, however, he noted that public demand for some consumer goods was going unsatisfied and deplored the presence of queues. He went on to say:

We must do all we can to see to it that our economy constantly satisfies the rapidly growing requirements of the people. Otherwise there may turn out to be a gap between the resources of the purchasers and resources for the satisfaction of their demand. This is fraught with dangerous consequences.

The best single measure of the failure of the state to drain off excess purchasing power is the margin between food prices at state stores and at the collective farm markets, which sell mostly perishable goods at prices

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determined by supply and demand. Between 1959 and 1962, prices on the collective farm market increased from 31 percent higher than those at state markets to 44 percent higher. These differences are far less marked than in the period 1950-55--when the government was reducing prices in state stores--but do show a significant trend.

During 1960 and 1961 disposable income increased by 17.2 percent, while purchases of food increased by only 13.0 percent and of other consumer goods by 14.3 percent. Preliminary plan fulfillment figures indicate that this gap was not closed in 1962.

Economic Effects

In an economy relying primarily on planning of prices

from the center, inflation does not have the same impact it would in a market-oriented setting. In setting prices, however, the regime must consider the effect on incentives and morale. If prices are kept low, demand is not met and the resulting shortages lead to queuing and the use of waiting lists or other informal methods of rationing. Such devices are irritating and a constant reminder that living standards do not match Soviet progress in other areas.

If, instead, retail prices are raised so that demand is met, there may be a shock to consumer morale with the "dangerous consequences" of which Khrushchev warned. In following a policy of making general periodic retail price reductions before 1956 and selective price reductions since, the Soviet leadership

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may have conditioned the population to regard any increase in prices as a betrayal.

In terms of effect on output, inflation probably has its greatest effect in reducing the supply of labor. Marginal workers--such as married women and the elderly--tend to withdraw from the labor force when income cannot be used. Inflation also encourages agricultural workers to shift their efforts to private plots at the expense of kolkhoz or state farm work in order to take advantage of the higher prices at the collective farm markets. Excess consumer demand flows into these markets, raising prices and increasing the incomes of agricultural workers at the expense of the urban worker. Finally, the accumulation of idle cash in the hands of the population encourages speculation--a favorite target of the regime.

Leadership Actions to Deal With Inflation

Since 1959 the Soviet leadership appears to have elected to give investment and military needs priority while consumer-oriented output struggles on as best it can. Once it is accepted that the growth in output of consumer goods and services will not be able to match previous performance, a strict supervision of the growth in consumer incomes is required.

In 1962 some first steps were taken to deal with the emerging inflationary situation.

The increase in the price of meat and butter last June somewhat reduced excess consumer purchasing power and demand. The effect of this move, however, was somewhat offset by the fact that it was accompanied by an increase in procurement prices paid to producers of these products--a move justified as necessary to provide additional incentives to agricultural production.

Khrushchev, in discussing the price increases before a Cuban youth meeting on 2 June, pleaded for an understanding of the necessity for the move. The collective farmers, he said, "accepted well" the decision because it increased their incomes, but the urban population which would purchase meat at higher prices "is accepting it differently." Then he warned bluntly that "it is necessary to understand and explain this, and to check those who do not understand or want to understand."

The rise in price of meat and butter was followed in September by a "temporary" suspension of further income-tax cuts, eliminating one means of increasing consumer incomes. The scheduled reduction in the workweek from 41 to 40 hours evidently has also been shelved, thus avoiding some of the loss in output that the hours reduction program has brought in earlier years, particularly in the consumer goods industries.

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The public reaction to the retail price increases must certainly have been greater than expected. During June various reports said consumers were "irate," and that there was "grumbling" and "a definite disappointment." Before long there were a number of additional reports and rumors which described riots at Novochoerkassk, Kemerovo, Aleksandrov, and Groznyy, and demonstrations in some ten other localities. Apparently such a riot did take place at Novochoerkassk and possibly at Kemerovo. The bulk of the reasons cited in the reports for the civil disturbances of the past year--unlike the reasons cited after disturbances of previous years--were related to consumer grievances.

Policy Implications

The inflationary pressures of the past few years do not measure up to those which the USSR has handled before with little difficulty. Stalin allowed wages to run ahead of productivity gains in order to preserve maximum production incentives. When necessary, he raised retail prices or confiscated savings. Fundamental to the success of his policies was an iron control over the population and a disregard of their reactions.

However, Khrushchev has taken a different approach. He probably feels that de-Stalinization is irreversible in the

sense that rigid controls could not be reimposed without destroying incentives. The outbreak of civil disturbances in the USSR involving economic issues and the occurrence of analogous experiences in the satellites showed what can happen after a relaxation of police controls and coercion lessens the populace's fear of reprisals against protest of various kinds. The population is less docile now than in past years. The regime's realization of this makes choice among various alternatives in dealing with inflation difficult.

The experience of last summer is likely to discourage Moscow at least temporarily from further frontal attack on the problem. Soviet leaders seem more likely to temporize, in the hope that economic performance will improve or that military spending can be held down. Rather than raising prices, either across the board or in selected products, the regime might try to drain off surplus income through some scheme of forced savings such as compulsory bond purchases. Some limitation on labor mobility might be imposed to curb pressures for wage increases in the present tight labor market. If output continues to lag and inflationary pressures to increase, a somewhat larger allocation of resources to consumer goods might be made in preference to direct action to reduce consumer purchasing power. (CONFIDENTIAL)

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